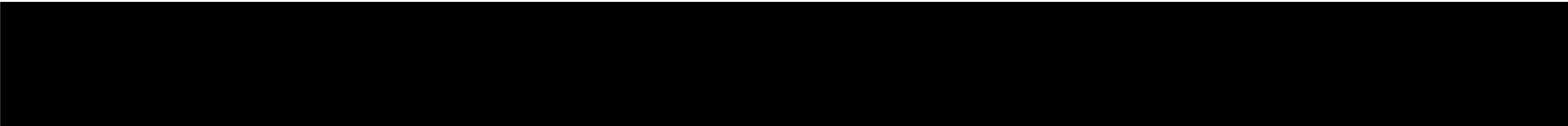


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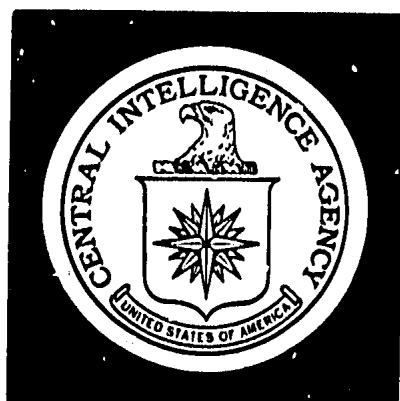
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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Japan's Sensitivity To Higher Prices For Imported Oil

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
December 1970

INTELLIGENCE MEMORANDUM

Japan's Sensitivity To Higher Prices
For Imported Oil

Introduction

Tokyo's efforts to reduce the price it pays for imported crude oil were highly successful during the 1960s. However, recent and pending agreements between international oil companies and the main producing states are likely to reverse this trend in the near future. Higher payments to the producing countries would reduce oil company profits further unless the increased costs are passed along to consumers. The extent to which the companies can charge Japanese buyers higher prices will depend on the relative bargaining strengths of the two sides. This memorandum examines the influences on the prices paid by Japan for crude oil and assesses the possible impact of increased prices on US-Japanese relations.

Japan's Oil Import Policy

1. Petroleum provides a large and growing share of Japan's energy needs. The proportion stood at three-quarters in 1969 and is expected to reach four-fifths by 1975. Coal is an important energy source but, because of its poor quality and the high cost of mining, Japanese coal output is declining. Waterpower resources are not large

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and are almost fully exploited, and the contribution of nuclear power is expected to remain small for some time. With total energy requirements growing rapidly -- at an annual rate of about 10%, the same as real GNP -- oil demand has increased at a rate of 18% annually since 1960. Domestic crude oil production is negligible -- 5.5 million barrels in 1969. Japan therefore must import nearly all its crude oil requirements; in 1970 imports amounted to about 1.2 billion barrels.

2. Japanese crude oil demand is likely to continue growing rapidly. Various estimates place this demand at 2.2 to 2.6 billion barrels in 1975. The CIA estimate based on an assumed rate of real GNP growth in Japan of 10.6% annually and a calculated relationship between real GNP and crude oil imports, is 2.3 billion barrels.* This estimate implies that Japanese demand will increase nearly 14% annually, a rate about double that expected for the rest of the Free World.

3. The importance of petroleum makes its supply and cost issues of singular concern to Japan. The Japanese government takes an active interest in assuring that an adequate supply of crude oil is obtained at the lowest possible price. Although Tokyo has been trying to obtain its own overseas supplies, US and European oil companies still provide most of its imports (see Table 1).

* *Least squares regression analysis using data for the period 1960-69 yields the following equation:*

$$CM = -385.2 + .02842 JNP$$

(-18.1) (45.5)

$$RB2 = .396 \quad DW = 1.86$$

where: CM = Japanese imports of crude petroleum
in millions of 42-gallon barrels.
JNP = Japanese GNP in billions of yen at
constant 1965 prices.

Figures in parentheses are the Student's Ts.
RB2 is the coefficient of determination.
DW is the Durbin-Watson statistic. The value derived indicates that virtually no serial correlation exists.

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Table 1

Japan: Crude Oil Imports
by Nationality of Supplying Company
1969

| | <u>Percent of Total</u> |
|-------------------|-------------------------|
| US | 53 |
| Joint US-Japanese | 5 |
| British | 12 |
| French | 3 |
| Japanese | 11 |
| Others | 16 |
| <i>Total</i> | <i>100</i> |

4. The current (1970) Japanese oil import bill exceeds \$2 billion -- an increase of nearly four-fold in the past decade. But the cost would be considerably greater if import prices had not declined. During 1961-69 when Japanese demand for imported crude oil by volume increased more than four-fold, the average delivery price paid by the Japanese for a barrel of crude oil decreased by 24% (see Table 2). If Japan were still paying 1960 prices for crude oil, the 1969 import bill would have been almost \$600 million higher and its 1969 actual trade surplus of \$950 million would have been reduced to \$350 million.

5. The price decline is attributable to reductions in both transportation costs to Japan and oil prices on the world market. Since the late 1950s the proliferation of new producing countries has reduced the control of the established international companies over the oil market, while oil production capacity has grown faster than demand. The result was downward pressure on prices, and the Japanese were in a strong bargaining position to take advantage of the opportunity. Tokyo's

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Table 2

Japan: Imports of Crude Oil

| | <u>1960</u> | <u>1961</u> | <u>1962</u> | <u>1963</u> | <u>1964</u> | <u>1965</u> | <u>1966</u> | <u>1967</u> | <u>1968</u> | <u>1969</u> |
|----------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Value (million US \$) | 465 | 539 | 621 | 789 | 929 | 1,047 | 1,200 | 1,457 | 1,685 | 1,907 |
| Quantity (million barrels) | 196 | 244 | 290 | 375 | 454 | 529 | 625 | 759 | 880 | 1,053 |
| Price (US \$ per barrel) | 2.38 | 2.21 | 2.15 | 2.11 | 2.05 | 1.98 | 1.92 | 1.92 | 1.92 | 1.81 |

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bargaining strength stems from its control of the world's fastest growing large market for imported crude. Control is exercised primarily through the refinery industry. The Japanese Ministry of International Trade and Industry (MITI) allocates refinery capacity, passes judgment on proposed participation by foreign companies in the refinery industry, and keeps a watchful eye on the contractual sales agreements between the refineries and the foreign crude oil suppliers.

6. Tokyo also has cut oil import costs by building larger and more efficient tankers and has stabilized transport charges by carrying 85% of its crude oil in vessels under long-term charter. Japan was relatively unaffected by the sharp rise in tanker rates that followed the closure of the Suez Canal. Between 1965 and 1969 the average freight and insurance cost on a barrel of imported crude oil actually dropped from about \$0.52 to about \$0.42.

7. The Japanese also paid less per barrel for delivered crude oil than did West European countries during the 1960s (see Table 3). In the early part of the decade, when both areas received most of their oil from the Persian Gulf, the Japanese received a price advantage because transportation costs to Japan were cheaper than to Western Europe. When large-scale production from North Africa came on the world market in the mid 1960s, it had the effect of lowering crude oil prices. Despite North Africa's nearness to Western Europe, however, delivered prices of crude in Europe fell no more than in Japan.* Moreover, as the closure of the Suez Canal raised the cost of transporting Persian Gulf oil to Western Europe, Japan's transportation cost advantage increased. Delivered prices rose in Western Europe; the delivered price differential grew from an average of about \$0.30 prior to 1967 to about \$0.40 per barrel thereafter. Since the 1970 tanker crisis caused by the closing of

* In 1969 about 26% of the crude oil shipped from the Persian Gulf went to Japan and 47% to Western Europe.

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Tapline and the rationing of production by the new Libyan government, the Japanese cost advantage probably continued to expand.

Table 3

Average Delivered Price of Crude Oil

| <u>Year</u> | <u>US \$ Per Barrel</u> | | <u>Price Differential (US Cents . Per Barrel)</u> |
|-------------|-------------------------|---------------------------------------|---|
| | <u>To Japan</u> | <u>To European OECD Countries</u> | |
| 1960 | 2.38 | 2.66 | 28 |
| 1961 | 2.21 | 2.54 | 33 |
| 1962 | 2.15 | 2.47 | 32 |
| 1963 | 2.11 | 2.42 | 31 |
| 1964 | 2.05 | 2.36 | 31 |
| 1965 | 1.98 | 2.27 | 29 |
| 1966 | 1.92 | 2.14 | 22 |
| 1967 | 1.92 | 2.30 | 38 |
| 1968 | 1.92 | 2.35 | 43 |
| 1969 | 1.81 | 2.22 | 41 |

Prospects for Prices

8. Japan hopes to cut the price of oil further. MITI,* in 1965, set a goal of lowering the average

* In the years immediately after World War II, the posted price for crude oil sold in the Persian Gulf was both the actual selling price and the price used to determine the relative profit shares of the oil companies and the host governments. In recent years, Persian Gulf crude oil [footnote continued on p. 7].

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f.o.b. price Japan pays for crude oil by \$0.15 per barrel, from \$1.46 to \$1.31 in the year ending 31 March 1971. Only about half of this goal had been achieved by the end of 1969 when the average f.o.b. price stood at \$1.39, and Tokyo continues to press for further reductions. Recent developments in oil-producing countries, however, make such reductions highly unlikely.

9. Iran, Japan's most important supplier (see Table 4), recently negotiated an increase of about \$0.10 a barrel in the revenue received from the oil companies. Kuwait subsequently achieved a similar increase, and the remaining Persian Gulf producers are expected to follow Teheran's lead shortly. The oil companies, attempting to maintain profit margins, will try to pass along to their customers the increased costs of higher payments to the host governments. Disturbed by the prospect of increased oil prices, Japanese petroleum importers, undoubtedly with the approval of the Japanese government, asked Iran to reconsider the planned price increase on sales to Japan.

10. Iran is unlikely to agree to Japan's request and is seeking even larger oil revenues. As part of this effort, Teheran has mentioned boosting its revenues beyond the recent \$0.10 per barrel hike by an increase of \$0.20 to \$0.30 a barrel in the posted price on oil they sell to Japan (but not to other buyers). Iranian government officials argue that this discriminatory hike, when passed on by the oil companies, would equalize the landed cost of crude oil in European and Japanese markets. In essence, Iran would reap the cost advantage Japan now enjoys in buying Persian Gulf crude. While Tokyo undoubtedly would be outraged if such a pricing scheme were pursued actively by Teheran and would vigorously oppose it, it has not yet

has been selling below the posted price which has nonetheless continued to be used to determine profit shares. The effect of this has been to squeeze oil company profits by altering the profit split increasingly in favor of the host governments. Thus further increases in posted prices mean an immediate increase in government revenues. They do not mean, an increase in oil company profits, however, unless the companies can pass much of the increase along to their customers.

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Table 4

Japan: Imports of Crude Oil
by Supplying Region

| <u>Year</u> | <u>Percent of Total</u> | | | |
|-------------|-------------------------|-------------------------------|------------------|--------------|
| | <u>Iran</u> | <u>Other Persian Gulf</u> | <u>Indonesia</u> | <u>Other</u> |
| 1960 | 4 | 61 | 11 | 24 |
| 1961 | 6 | 62 | 12 | 20 |
| 1962 | 12 | 62 | 11 | 15 |
| 1963 | 15 | 62 | 10 | 13 |
| 1964 | 20 | 60 | 9 | 11 |
| 1965 | 21 | 59 | 7 | 13 |
| 1966 | 28 | 56 | 6 | 10 |
| 1967 | 35 | 53 | 6 | 6 |
| 1968 | 37 | 52 | 8 | 3 |
| 1969 | 42 | 48 | 10 | 0 |

commented on this latest Iranian demand. Even if Iran does not go through with an increase in the posted price to Japan, this gambit raises the probability of Iran's rejection of the Japanese request to rescind the \$0.10 a barrel hike.

11. Higher payments to the governments of oil-producing countries are not the only force pushing up oil prices in Japan. To deal with its pollution problem, Japan will have to increase the share of more costly low-sulphur oil in its imports or desulphurize other types of crude oil. Higher costs would result in either case. Japan is likely to continue to realize increased savings in transport costs as a larger share of oil imports are carried by mammoth tankers. The interplay of forces bearing on the delivered price of oil suggests that

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Japan would be most fortunate to hold the present level. On balance, one would expect delivered prices to increase.

Implications for the United States

12. The basic cause of higher oil prices is the increase in the per barrel revenues of the oil-producing countries. The profits of the major international oil companies have not been growing over the past three years and are a relatively small component of total delivered prices. However, US companies supply more than half of Japan's oil imports, and based on this marketing relationship, Japanese criticism of the US government could result. Most important Japanese leaders do not share extreme anti-US views and do not consider oil pricing to be a real issue between the United States and Japan. In the somewhat strained present stage of US-Japanese economic relations, however, the Japanese leaders may not wish to publicly refute a new cause for popular criticism of the United States.

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